



**STATE INVESTMENT BOARD
BOARD ADOPTED POLICIES**

POLICY NUMBER: 2.10.600

EFFECTIVE DATE: 4/19/01

TITLE: Real Estate Investment Program

SUPERSEDES: 3/16/95

BOARD ADOPTION: 4/19/01

APPROVED: *James F. Parker*

PURPOSE:

This section sets out the general policies, objectives and guidelines for the State Investment Board's (SIB) real estate investment program. The purpose of the real estate investment program is to prudently employ the assets the SIB has allocated to real estate to produce a well-diversified profitable portfolio, which will enhance the total return of the SIB portfolio, ultimately pay benefits to beneficiaries, and contribute to the overall achievement of actuarial requirements. The SIB recognizes the return premium periodically obtainable in the private markets; therefore, the SIB real estate investment program will seek to achieve a risk-adjusted return premium over comparable public market investments.

The real estate investment program is one of several asset classes among which assets are allocated. Given current funding and liquidity requirements of the retirement funds managed by the SIB, as well as the current returns being achieved in the other asset classes, the SIB has determined that both the longer term nature of real estate investments and the risk-adjusted return premium expected from this portfolio are prudent allocations consistent with the referenced requirements.

The policies governing the real estate investment program will apply to the existing SIB real estate portfolio, as well as new investments. To the extent possible and consistent with market opportunities, the existing portfolio will be modified to conform to the policies and procedures contained herein.

POLICY:

Objectives and Goals

The objectives and goals of the real estate investment program are to:

1. Maximize returns at a prudent level of risk by investing in real estate assets, which can be expected to deliver a long term (greater than five years) risk-adjusted return premium over the National Council of Real Estate Investment Fiduciaries Property Index. While the SIB will always strive to achieve the best relative value, the expected return premium is 100-300 basis points.

2. Achieve prudent portfolio diversification.
3. Create *and actively monitor* an externally managed real estate investment program while ensuring that the SIB is cognizant of the overall portfolio's risk/return attributes.
4. Develop a risk management system designed to ensure the integrity of the real estate investment program and protect the long-term capital value of the SIB's assets through the implementation of standardized procedures designed to proactively monitor real estate investments.
5. Assess the real estate investment program's performance, strategies, and objectives on a continuing basis to permit both a timely and flexible response to changing circumstances.
6. Prudently achieve the Board-approved asset allocation objectives for the real estate sector.
7. Endeavor to provide ancillary benefits to the SIB through the negotiation of special terms and conditions. Continue to develop and enhance the program's status as a leading real estate institutional investor.

Scope of Acceptable Investments

The SIB can invest in any real estate investment opportunity demonstrating superior risk-adjusted returns provided such opportunities are not prohibited by Board policy or by law. The SIB will seek to establish a prudent and disciplined approach to achieving a well-diversified portfolio of real estate investments that should achieve superior risk-adjusted returns as an asset class. To meet return and plan objectives, it is prudent to diversify the real estate portfolio among the universe of real estate investments, within defined risk management constraints and staff resources. Notwithstanding, diversification shall remain an objective to achieving an appropriate risk-adjusted return, but diversification alone shall never be the primary objective of the real estate investment program. Every investment will be defined and analyzed according to its relative risk/return attributes.

The SIB recognizes the return characteristics of real estate as consisting of varying proportions of expected cash yield and future appreciation. Prospective investments will be analyzed accordingly; in comparing prospective investments of comparable overall expected return, preference will be given to the investment with a greater cash yield component or seniority within the capital structure of the investment platform.

The SIB may invest in any legal investment structure. The primary consideration determining the appropriate investment structure will be to achieve the management structure deemed most appropriate

by the SIB for the respective investment under consideration. Relatively less liquid investment structures will be expected to achieve a return premium.

Investment structures may include the following:

1. Co-investments, joint ventures, limited partnerships, limited liability companies, real estate investment trusts (REITs), and real estate operating companies (REOCs), which are investments involving more than one investor, or that provide management equity participation, and correspondingly may provide varying degrees of management control and discretion. These structures are expected to represent the primary investment structure to be used by the SIB.
2. Commingled funds are defined as discretionary commingled investment structures, which will only be considered by the SIB on a select basis to achieve specific investment objectives.

Diversification

The SIB prudently seeks to diversify its investments cognizant of each partner's fundamental strategies and business plan. Investments should not be made solely to achieve product type or geographic diversification.

To meet return and overall plan objectives, it is prudent to diversify the real estate portfolio over time among the universe of real estate investments. That said, diversification can take many forms, including, but not limited to the following:

1. Property types: office, industrial, retail, multifamily and specialty;
2. Capital structure: equity, preferred equity, mezzanine, or senior debt;
3. Life cycle: stabilized, vacant, redevelopment, or ground-up development;
4. Leverage: partnerships will use varying degrees of third-party borrowings;
5. Geographic: the real estate should be broadly diversified by geographic regions and may seek to include investments outside the United States; and,
6. Concentration: attention must be paid to the amount that the SIB, or any investment in which it invests, should place in any one investment.

Diversification also requires recognition of the need to balance niche opportunities in a specific market area with generalist approaches in selecting real estate investment opportunities. A well-balanced portfolio should contain both niche and generalist type investments.

The following table provides a prudent and disciplined guideline to product type diversification based upon the relative asset base of available investments and the ability to achieve diversification targets through the public securities market. Product type diversification will be assessed against the NCREIF index as a frame of reference of the size of the respective institutional investment market. Although specialty investments are not a defined category of the NCREIF index, such investments do represent a significant asset class and may provide an appropriate investment opportunity.

<u>Product Type</u>	SIB Diversification
	<u>Range</u>
Office	10-50%
Retail	10-40%
Warehouse	10-40%
Residential	10-50%
Other	10-40%

Given the importance of location to the long-term value of real estate, the SIB seeks to achieve diversification of investments based upon the economic fundamentals of regional areas. As a proxy for economic diversification, the distribution of real estate investments by geographic region will be monitored according to NCREIF indices with broad ranges of targeted allocation. Although no foreign investments are included in the NCREIF Index, such investments do provide significant investment opportunities for the SIB.

<u>Region</u>	SIB Diversification
	<u>Range</u>
West	10-60%
South	10-50%
Midwest	10-40%
East	10-40%
Foreign	0-25%

Valuation Policy

The SIB will strive to participate in real estate partnerships that align interests by addressing potential conflicts associated with issues pertaining to market valuations. This is accomplished by establishing asset management fee structures that are calculated based on factors not associated with market value estimates. In addition, the SIB attempts to negotiate terms allowing the SIB to challenge value estimates that are used in the payment of incentive-based performance fees. The SIB monitors each

partnership's unique valuation methodology to ensure that each contract is in compliance with stated partnership terms and conditions. The SIB also requests that annual audited financial statements contain a certification verifying that management is in compliance with partnership valuation procedures.

Implementation

The investment objectives and guidelines embodied in this policy will be put into effect by the appropriate Board Committee, the staff, and the consultant as set out in the procedures contained in Addendum A, with due regard for the real estate investment policies adopted. The procedures are intended to be a stable implementation mechanism to carry out the substance of this policy. This policy and its guidelines is to enable the SIB to be well-positioned and flexible enough to act on real estate investment opportunities as they arise.

Due Diligence

As outlined in Addendum A, the initial, and one of the most critical phases, of the real estate process is exhaustive due diligence by the consultant and staff. To facilitate this phase, the staff and consultants have each developed an independent process outlining the due diligence steps. These checklists serve as a minimum standard; there are many additional and subjective factors that need to be included to develop a recommendation. Conditions in the real estate market change through investment cycles. Individual factors, and their relative importance, can also change significantly. Due diligence includes, but is not limited to the following:

- analyzing past investment returns and performance;
- meeting with the principals in their office and/or the SIB's office;
- reviewing their business backgrounds and performing numerous reference checks;
- if applicable, reviewing the most recent audited partnership financial statements;
- reviewing the proposed business plan and exit strategies;
- identifying key issues and resolving them; and,
- reviewing the proposed terms, conditions, and fees of the partnership.

As such, the actual due diligence process will be regularly reviewed and adjusted. Much of the due diligence effort must focus on the selection of the investment partners. The due diligence process is intended to add to the effort, but it cannot substitute for thorough analysis and sound judgment.

Roles and Responsibilities

Board:

1. Monitor the performance of the overall real estate investment program.

2. Approve real estate policies and procedures.
3. Approve or delegate pursuant to Board-adopted Delegation of Authority policies.
4. Select qualified real estate consultants.
5. Approve the SIB commitments to real estate partnerships or other investment vehicles.
6. Approve major partnership restructurings.

Private Markets Committee:

1. Make recommendations to the Board for SIB commitments to real estate partnerships or other investment vehicles, major partnership restructurings, and changes to real estate policies and procedures.
2. Provide thorough oversight and review of the real estate investment program, in order to report and provide recommendations to the full Board.
3. Serve as a resource to SIB staff such that staff may receive direction and guidance on overall management decisions from the Committee consistent with Board-adopted policies.

Board Staff:

1. Implementation of Board-adopted policies.
2. Development of portfolio strategies in conjunction with the consultant for review by the Committee/Board.
3. Source, underwrite, and present investment opportunities for Committee and Board approval.
4. Ensure compliance of all contractual partnership obligations.
5. Represent the Board with respect to all matters related to the Board-approved real estate investments.

External Real Estate Consultant:

1. Provide the Board and staff with a continuing review of the SIB's overall real estate policies and recommend changes as appropriate.
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2. Assist the Board and staff with the formulation of portfolio strategies for review by the Committee/Board.
3. Source, underwrite, and present investment opportunities for approval by the Committee and Board.
4. Provide quarterly performance measurement reports on all existing and new real estate investments. Conduct specialized research as directed by staff or the Board.
5. *In connection with the real estate quarterly performance report, notify the Board of situations involving SIB's actual diversification characteristics deviating outside diversification parameters established by Board policy.*

Policy Adopted 5/20/93
Revised 9/15/94
Revised 3/16/95
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A schematic of the overall investment process is shown below:

	Consultant	Staff	Private Markets Committee	Board
Investment opportunity identified by Staff/Consultant	1 Consultant engages in thorough due diligence of investment.	1 Staff engages in thorough due diligence of investment.	4 Staff provides status report of all due diligence activity to the Committee, including findings of due diligence process.	
	2 Consultant gives written recommendation to the Committee.	2 Staff gives written recommendation to the Committee.	5 Fund principals make presentation to the Committee.	
	3 Consultant relays to staff comments regarding partnership key terms and conditions.		6 PMC makes recommendation to the Board.	
				7 Board approves or disapproves investment and commitment amount subject to partnership agreement negotiation.
		8 Legal agreements negotiated and reviewed by Attorney General, outside legal counsel, and SIB staff.		
		9 Executive Director executes legal documents.		

* Staff and Consultants' investment recommendation and the Board's approval/disapproval of that investment transpires in the same month.